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In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 152

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

vs.

INSURANCE SECURITIES INCORPORATED, TRUST FUND SPONSORED BY INSURANCE SECURITIES INCORPORATED, ABE P. LEACH, OSSIAN E. CARR, ARTHUR J. LONERGAN, ROY A. HAIGHT, and LELAND M. KAISER.

Brief for Respondents in Opposition to Petition for Certiorari

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OPINIONS BELOW

The opinion of the Court of Appeals (R. 174-188; Pet. App. 22-40)[1] is reported at 254 F.2d 642. The opinion of the District Court (R. 142-150) is reported at 146 F. Supp. 778.

JURISDICTION

The judgment of the Court of Appeals was entered on April 7, 1958 (R. 189). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

1. The abbreviation "Pet. App." refers to the Appendix to the Petition. All emphasis in quotations in this brief has been added unless otherwise noted.

STATUTES INVOLVED

Section 36 of the Investment Company Act (54 Stat. 789, 15 U.S.C. § 80a-35) provides:

> "The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after the enactment of this title and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:
>
> "(1) as officer, director, member of an advisory board, investment adviser, or depositor; or
>
> "(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.
>
> If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate."

Other important provisions of the Act are Sections 1(b)(6), 2(a)(4), 2(a)(9), and 15. Because of their length they are quoted in an appendix.

QUESTIONS PRESENTED

Both courts below have held that the question petitioner seeks to proffer (p. 2) is not presented, for it assumes a legal conclusion both courts held to be baseless.

A corporation performs for an investment company the services of investment advice, sales and administration. Several stockholders and directors of the service company sell the stock they own in *that* company (not in the investment company) to third persons (not the investment company or investors therein). Admittedly there is no claim of mismanagement or misappropriation of any of the assets of the investment company, of failure to conduct its business efficiently or honestly, of any conduct relative

to its investments or portfolio, or of loss or damage to it or its investors.

The question is this: Does the Investment Company Act of 1940[2] regulate the sale by a stockholder of his stock in the service company to a third person or limit the price? Does the sale become a "gross misconduct or gross abuse of trust *in respect of* [*the*] *investment company*" under Section 36 of the Act, where the quantity of stock sold constitutes control of the service company, because the price is greater than the book value of its physical assets?

The Court of Appeals phrased the question thus (Pet. App. 32):

> "The specific question presented by appellant's argument is whether transfer of control of an investment adviser and principal underwriter at a price in excess of net asset value constitutes 'gross misconduct or gross abuse of trust in respect to' an investment company which it serves, within the meaning of § 36 of the act."

STATEMENT OF THE CASE

"Trust Fund", located in California, is an "investment company" within the meaning of the Act.[3] It sells participation agreements to investors and invests the proceeds in insurance company stocks (R. 5). The trustee is a California bank (R. 22) not a party to this suit.

Respondent Insurance Securities Incorporated (sometimes called ISI and hereafter called the service company), a California corporation, had a contract with the Fund (authorized by vote of the investors), under which the service company performed three types of services for the Fund: (a) It was "principal underwriter", i.e., it acted as salesman of participation agreements; (b) it was "investment adviser", i.e., it advised what insurance

2. Hereafter called the "Act."

3. While named as a defendant, no relief was sought against Trust Fund, and it never appeared in the action, although its name still appears in the caption.

stocks the Fund should buy; and (c) it performed administrative duties. As compensation, the contract provided for payment of a fee for each type of service. Such a contract is admittedly recognized by the Act as lawful.

Being a corporation, the service company had its own stockholders, and the four respondents Leach, Carr, Lonergan and Haight were some of its stockholders and directors (R. 4, para. 2; R. 7, para. 14). They are hereafter referred to as the "individual respondents".[4] None of them was an officer, employee or director of the Fund at any time referred to in the complaint.[5] Over a period of months following January 1956 each of them sold some of his stock in the service company (not in the Fund) to one or more third persons not connected with the Fund, at $50 per share. Like any service corporation, the service company's physical assets were relatively small and the book value of the physical assets was $1.81 per share.

As required by Section 15 of the Act, the contract between the service company and the Fund provided for its automatic termination upon assignment (R. 6, 7, para. 11). Section 2(a)(4) of the Act provides that the term "assignment" is deemed to include any transfer "of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; * * *." Section 2(a)(9) provides that any person who beneficially owns more than 25% of the voting securities of any company shall be presumed to control that company. None of the individual respondents owned, and no buyer bought, as much as 25% of the service

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4. Another defendant, Leland M. Kaiser, is designated in the caption of the complaint as "Attorney and Proxy for investors of Trust Fund" (R. 3) and was "made a party defendant herein in his capacity as proxy and attorney on behalf of investors of a 'Trust Fund' " (R. 4). Count One of the complaint charged him with no act and no wrongdoing and sought no relief against him. (See opinion of the Court of Appeals, Pet. App. 27, fn. 3.) While the Petition speaks loosely of "individual defendants" (e.g., pp. 5, 6), it means Leach, Lonergan, Carr and Haight, and would be incorrect if it included Kaiser, who did not become an officer or director of the service company until February 1956 (R. 37).

5. As the complaint alleges, the Fund had no officers or directors. (R. 6, para. 8)

company's stock. But treated in the aggregate, more than 25% was sold. On the possibility that a transfer of control of the service company might be deemed to have occurred, the investors in the Fund were notified that the service contract may have terminated, and the question whether a new service contract should be entered into was placed before them for vote on August 15, 1956, and proxies were solicited. Petitioner sued and obtained a restraining order on August 14th (R. 48), but the restraint was dissolved on stipulation (R. 93), and a *new* service contact was entered into between the service company and the Fund upon the investors' affirmative vote (R. 141).

Petitioner's complaint did not object to any conduct of the service company.[6] What it assailed was the sale by the individual respondents of their personally owned stock in the service company. The final relief for which it prayed was threefold (R. 14, 15; Pet. App. 29): (1) To enjoin the four individual respondents from serving as officers and directors of the service company or of the Fund; (2) to compel them to pay to the Fund the difference between the price they received for their stock and the $1.81 per share of physical asset value; and (3) to enjoin the service company from performing services for the Fund, despite the authorization by vote of the investors of the new service contract, solely because of the sale by the individual respondents.

Concededly the Act does not prohibit a sale by stockholders in a service company of their stock or in terms limit or regulate the price at which the stock may be sold. In default of any other basis, petitioner sought to rest on Section 36. But the sole scope of that section is to authorize the petitioner to sue for an injunction

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6. While the complaint is in two counts, Count Two merely sought to enjoin the voting of the proxies, and it has been conceded (Pet. 9, fn. 7; Pet. App. 40) that Count Two was dependent upon Count One and failed if Count One failed. Separate consideration of Count Two is therefore unnecessary, although that count possesses its own independent deficiencies, and we refer to Count One as the complaint. As the allegations about proxies are irrelevant to Count One, we pass by statements about them in the petition.

against a person, continuing to act in certain capacities in which he has been "guilty * * * of gross misconduct or gross abuse of trust in respect of any registered investment company."[7]

Thus the gist of the complaint is the claim that the individual respondents committed a "gross abuse of trust" *with respect to the Trust Fund*. Yet petitioner admitted (R. 50, 89):

> "that the action does not concern the investments in insurance stocks nor the portfolio of the Trust Fund, nor the manner in which Insurance Securities, Inc., has managed the funds invested in Trust Fund.
>
> "The complaint does not allege that the defendants have mismanaged or misappropriated any of the assets of the Trust Fund."

And as the District Court said in its opinion (R. 147):

> "No claim has been made in the complaint or otherwise that the business of Trust Fund has not been conducted efficiently or honestly or that the investors of Trust Fund have suffered any loss or damage of any kind with respect to their interest in Trust Fund by reason of any act or conduct of Service Company, or its officers or directors."

The whole basis of the claim that the individual respondents committed a "gross abuse of trust" *with respect to the Fund* is the assumed fact that they sold a controlling block of stock in the service company plus the fact that the price was greater than book value of the physical assets.[8] *This is the sum total,* for there was no "self-dealing", no case of anyone in control dealing with his or its beneficiaries. The transactions—the sales of stock in the service company by its stockholders—were transactions with outsiders and not with the Fund. No respondent bought anything from, or sold anything to, the Fund. There was no diversion, use or waste of trust assets.

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7. For brevity we hereafter use the phrase "gross abuse of trust" to include the phrase "gross misconduct".

8. And the only complaint against the service company is that the alleged misconduct of the individuals was chargeable to it.

The District Court dismissed the complaint (R. 151), and the Court of Appeals unanimously affirmed (R. 189)[9]. Addressing itself to the question as petitioner posed it and as we quoted it on page 3 above (Pet. App. 32), that Court said:

> "As so framed, the question assumes, for the purposes of argument, that under the facts alleged, the control of the service company was transferred,[10] and that this was accomplished by persons of the class specified in § 36,"[11]

and it concluded (Pet. App. 40):

> "We hold that the terms 'gross misconduct' and 'gross abuse of trust,' as used in § 36 of the act, were not intended to embrace a transaction of the kind described in the amended complaint. It follows that the first cause of action fails to state a claim upon which relief can be granted. It is not necessary to consider the several additional reasons advanced by appellees why the trial court reached the correct result with respect to the first cause of action."

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9. Petitioner did not apply for a stay of mandate, and the Court of Appeals' mandate went down on May 16, 1958.

10. Since no seller sold and no buyer bought as much as 25% of the stock, this assumption required petitioner to aggregate all four sellers and all sales as a unit, on the one hand, and all the buyers and all their purchases, as a unit, on the other. Respondents challenged the complaint as making any such allegation, and by motion for summary judgment they also assailed the allegation, if made, as a sham. However, both courts assumed the fact, *arguendo,* to be as petitioner claimed.

11. This second assumption, that the individual respondents fell in some capacity to which Section 36 relates, was also challenged by respondents. That section authorizes an injunction against persons who have committed "gross misconduct or gross abuse of trust" in certain capacities, viz., in (a) the capacities of investment adviser, depositor (not here involved) or principal underwriter of the investment company, and (b) the capacities of officer, director or advisory board member *of the investment company.* It extends to no other capacities. Here the service company—not the individual respondents—was the investment adviser and principal underwriter, and it did not perform the acts assailed, the sale of stock. The individual respondents were not officers, directors or advisory board members of the investment company—the Trust Fund—but officers and directors of the service company. The Court of Appeals did not pass on this contention but assumed petitioner's position, *arguendo.*

ARGUMENT

1. This suit is an attempt of an administrative agency to enforce its own notions of what public policy ought to be without the slightest basis in any statute or any congressional authorization. Petitioner's argument, to borrow an observation in *Lauritzen v. Larsen*, 345 U.S. 571, 593, "is misaddressed. It would be within the proprieties if addressed to Congress." This is what both the District Court (R. 149) and the Court of Appeals (Pet. App. 39) have said here.

We deny petitioner's assertion (pp. 9, 21) that a construction by this Court is important to the administration of the Act. The case is not one where guidance is sought as to the kind of rules or regulations an administrative agency may issue, for the Act delegates no authority to petitioner to issue any on the subject.

Moreover, petitioner has already received a construction from two courts and four judges. Admittedly (p. 20) the decision does not conflict with any other court, and it can hardly be the law that whenever counsel for an agency conceives an exaggerated opinion of a statute, as here, the agency is entitled to a construction by this Court. No other cases are now pending in lower courts involving any similar question requiring this Court's action. The question *is not* one which is constantly arising.[12] If it should recur, and if petitioner should then be able to persuade another Court of Appeals to its view, a conflict may then be presented warranting consideration by this Court in orderly course.

2. Petitioner's case is palpably without substance. Here was a sale of stock at a price agreed on between buyer and seller.

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12. Out of its own files petitioner (p. 20, fn. 18) refers to but one "uncontested case", and even then the S.E.C. releases cited do not support its description but show that a different question was involved. There passage of stock in a service company to the owner's executors on his death was an assignment to them, terminating the service contract unless exemption were granted under Section 15(a), and exemption was sought. Since the executors occupied no office in either the service company or the investment company, no disposition by them of the stock could fall under Section 36 even under petitioner's theory. There is nothing to show that they had any opportunity to sell the stock at any price or to dispose of it other than by redemption by the service company.

"[B]efore transactions otherwise legal can be outlawed or denied their usual business consequences, they must fall under the ban of some standards of conduct prescribed by an agency of government authorized to prescribe such standards—either the courts or Congress or an agency to which Congress has delegated its authority." *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80, 92. And Congress has not purported to regulate the price at which stock in a service company may be sold or delegated any authority to petitioner to do so.

Petitioner seeks succor in the legislative history. But both courts below carefully reviewed that history and concluded, in the words of the Court of Appeals (Pet. App. 38):

> "Nor do we find anything of consequence in the legislative history of the act which would support [petitioner's] conclusion. The pertinent problem with which Congress was asked to deal was not the excess price received for the sale of a controlling interest in the stock of investment advisers. Rather, it was the transfer of control of investment advisers exercising management functions, or their assignment of the service contract to others, *without the consent of the investors*, regardless of the consideration received therefor. Congress recognized this problem in § 1 (b) of the act, and provided a specific remedy in § 15 (a) (4)."

In short, the concern of Congress was that when a service contract or control of a service company is transferred, the security holders shall have the right to approve or reject the continuation of the contract. To effectuate this concern Congress prescribed a specific remedy; that any such transfer terminates the contract, leaving it up to the investors to authorize a new contract or not (Section 15(a)(4)). This is the only protection Congress thought it necessary to give the investors. And in this case the protection which Congress provided was enjoyed.

Changes in the bill before passage demonstrate the fact. Thus Section 1(b), which states the "national public interest and the interest of investors" which the Act is designed to protect, declares in subd. (6) that these interests are adversely affected

> "when investment companies * * * or when the control or management thereof is transferred without the consent of their security holders."

As the Court of Appeals notes (Pet. App. 39):

> "In its original form, these additional words appeared at the end of this subdivision: '* * * *and without adequate public supervision.*'
>
> "In the final form of this subdivision, the quoted words were deleted. This indicates that Congress believed that the only remedy which was necessary with respect to this particular practice was the provision of § 15(a)(4) for automatic termination."

3. This provision for automatic termination demonstrates the fallacy of the "question" petitioner proffers, for it sweeps away the assumption on which petitioner's question is based. That question assumes that sale of controlling stock *of a service company* transfers control of the investment company and constitutes a sale of a "fiduciary position". But a transfer of control *of the service company* cannot be a transfer of control *of the investment company*, for its automatic effect under the Act is to terminate the service contract. A fiduciary relation can exist between the service company and the investment company *afterwards* only if the investors see fit to authorize a new contract. Since by Section 15 Congress specifically empowered the investors to reinstate the contract after termination, a prohibition of reinstatement cannot be inferred into some other section. As the Court of Appeals said (Pet. App. 35):

> "If this is permissible under § 15, it ought not to be subject to injunctive restraint under § 36. A practice which Congress authorized in one part of the act should not be held to be impliedly prohibited in another. *62 Cases of Jam v. United States*, 340 U.S. 593, 599-600."

4. Petitioner's case rests on the price paid for the stock. But Congress said nothing about price. Its sole concern was that the investors have a right to consent or refuse consent to a continuance

of the service contract. As the Court of Appeals said (Pet. App. 34):

> "The circumstance which is objectionable under this statutory pronouncement is transfer of control without consent, however achieved and whatever the consideration thereof. No language used in this section, or elsewhere in the act, indicates that the price paid for such a transfer of control is a circumstance to be considered.
>
> * * * * * * *
>
> "* * * the sanction runs against any assignment, whatever the price paid and received therefor. An assignment at net asset value is just as fruitless under this section as one for a substantial price in excess of such value. In either case, the contract is automatically terminated. In no respect is the amount paid or received for stock control made a factor to be considered."

When Congress, by Section 15, authorized the investors to vote for a new contract it made "no exception * * * in the case of an assignment in connection with which a substantial consideration was received in excess of net asset value" (Pet. App. 35).

5. The core of petitioner's case is its dissatisfaction with Congress' handiwork. This is openly revealed by the statement (Pet. 20),

> "Through the exercise of their franchise under Section 15 investors may not approve management's choice of successor, but this seems to us an unrealistic and an ineffective means to meet the problem."

Simply stated, petitioner lacks the faith that Congress had in the investor and his ability to act without petitioner's tutelage. But Congress showed, in the many detailed pages of the Act, an ability to state exactly what it wished to provide. If a further remedy was desirable, Congress could have provided it. It did not do so. Petitioner simply seeks "to extend the scope of the statute beyond the point where Congress indicated it would stop", and this it may not do. *62 Cases of Jam v. United States*, 340 U.S. 593, 600; *Wilder Mfg. Co. v. Corn Products Co.*, 236 U.S. 165, 174; *Colgate Co. v.*

Labor Board, 338 U.S. 355 at 363. A statute cannot be expanded by belittling the remedy Congress has provided. *Bruce's Juices v. American Can Co.*, 330 U.S. 743, 750, 752; *Switchmen's Union v. Board*, 320 U.S. 297, 301.

As the Court of Appeals said (Pet. App. 39):

> "Appellant's brief expresses considerable doubt as to the efficacy of the remedy provided by this section [Section 15]. If this is a well-grounded fear, a legislative and not a judicial problem is presented."

Petitioner's effort to read unexpressed prohibitions into the Act ignores the admonition of *Addison v. Holly Hill Co.*, 322 U.S. 607, 617, that provisions in a statute "made in such detail preclude their enlargement by implication". It has been judicially noted that this Act is so detailed and precise as to leave no room for enlargement and amplification by speculation about supposed policy. *Doyle v. Milton*, 73 F. Supp. 281 (S.D. N.Y.).[13] Cf. *Howard v. Furst* (2 Cir. 1956), 238 F.2d 790 at 793, cer. den. 353 U.S. 937.

The Act was a compromise between petitioner and the investment industry (Loss, "Securities Regulation", p. 97). On the industry's protest against loose standards in the original bills drafted by petitioner, the Senate Committee requested counsel for the two to redraft the bill together. As so redrafted, it was enacted.[14] As a result of the industry's submission that the prohibitions and restrictions to accomplish the goals endorsed by all should be pre-

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13. Granting a motion to dismiss, Judge Rifkind there said (pp. 284, 285):

> "The Investment Company Act is a carefully framed statute in which Congress has, with particularity, stated the means and methods, both judicial and administrative, by which its declaration of policy is to be executed. It has not confided in the courts a broad discretion to shape judicially contrived remedies for the mischief it has discovered. Insofar as power is entrusted to the courts under this Act its exercise must, of course, be steered toward the fulfillment of the national policy as declared. The policy itself, however, when declared in a statute as comprehensive and detailed as this Act, does not authorize the courts to fashion sanctions withheld by Congress."

14. For this history see Senate Report 1775, 76th Congr., 3rd Sess. p. 1; H.R. Report No. 2639, 76th Congr., 3rd Sess. p. 5.

cisely stated by Congress; the final Act was at least ½ again as long as the original bill and now occupies 39½ pages of fine print in the unannotated U. S. Code.

6. The text of the Act is empty of regulation of the price at which stockholders in a service company may sell their stock. The legislative history is empty of Congressional concern with price. And so petitioner would conjure up a regulation from the words "gross abuse of trust" in Section 36. Since petitioner thereby invokes supposed "historic equitable principles" (Pet. 10), the principle it proposes would not be confined to corporations serving investment companies. American law and economic life are replete with *corporate* fiduciaries who perform their services for an agreed fee. Trust companies do so. Insurance companies are fiduciary to those insured. What petitioner has asked the courts to do is to create a *new* rule, viz., that stockholders in any corporate fiduciary owe a duty to those using the fiduciary's services not to sell a controlling block of stock for more than physical asset value!

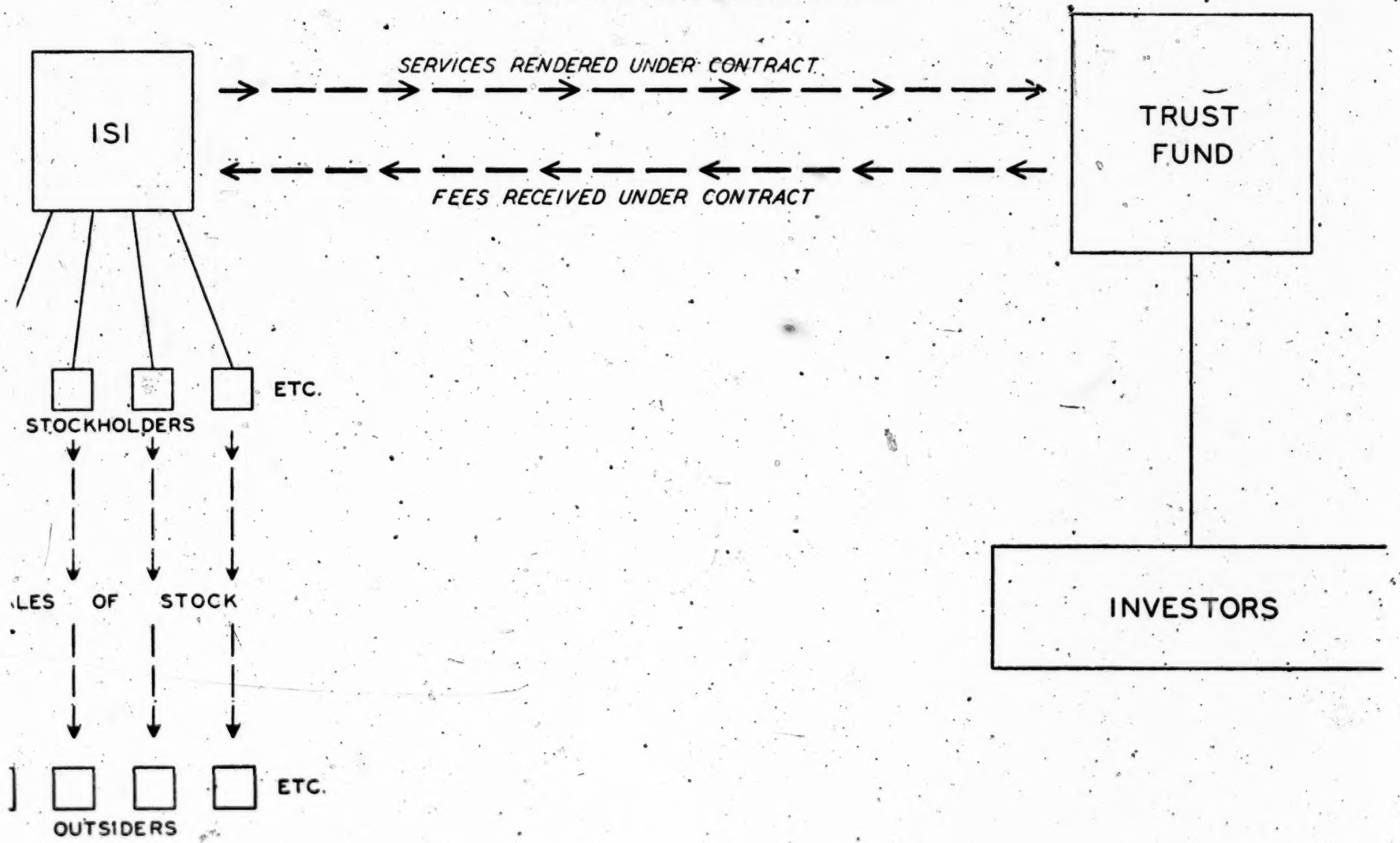
As said in *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80, 85:

> "We reject a lax view of fiduciary obligations and insist upon their scrupulous observance. * * * But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"

To expose a muddy handling of terms like "fiduciary", we used a schematic chart in the two courts below, which is shown on the following page. Relationships between the right and left sides of the chart—between service company and Fund in the performance of the duties assumed by the service contract—are fiduciary. But transactions between someone on one side, in respect of his own property, with an outsider, are not fiduciary to the other side at all.

The legislative history shows that by "gross abuse of trust" in Section 36 Congress referred to "self-dealing—that is, transactions

CHART SHOWING RELATIONSHIPS



between officers, directors, and similar persons on the one side, and investment companies with which they were associated on the other"[15], to conduct whereby the assets in the portfolio of the investment company are "misappropriated and diverted * * * and * * * employed to foster [the] personal interests" of the managers or whereby there is "unloading of securities upon the companies, unfair purchases from the companies, the obtaining of unsecured or inadequately secured loans from the companies, etc."[16] The same fact is shown by the only decision involving Section 36 cited by petitioner, *Aldred Investment Trust v. S.E.C.* (1 Cir.), 151 F.2d 254.[17] And the only other action involving Section 36, cited by petitioner, is of that character.[18]

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15. Testimony of Commissioner Healey of the S.E.C. before the House Committee; Hearings of the Subcommittee of the Committee on Interstate and Foreign Commerce, 76th Congr., 3rd Sess., on H.R. 10065, p. 59.

16. Senate Report No. 1775, 76th Congr., 3rd Sess., pp. 6, 7; H.R. Report No. 2639, 76th Congr., 3rd Sess., pp. 7, 8, 9.

17. There certain persons purchased shares in the investment company itself—a Massachusetts trust—, used their ownership to select themselves and their nominees as the trustees, and then used the trust's assets to buy horse race tracks so as to elect themselves directors and officers of the race tracks in order to draw fat salaries.

It will be observed that Section 36 does not speak merely of abuse of trust but of *gross* abuse of trust. In its brief in the *Aldred* case petitioner said (p. 11):

> "Section 36 deals only with a 'gross abuse' of trust and is intended to cover *such substantial deviation from the obligations of trusteeship as would indicate that the officers and directors involved cannot be entrusted with the management of other people's money* without substantial danger that the trust will be turned to the benefit of the manager rather than to the benefit of all classes of security holders."

18. In *S.E.C. v. Cryan*, S.D.N.Y. Civil Action No. 131-57, cited p. 17 of the petition, the complaint alleged, to quote petitioner, "that substantial sums were paid for the succession to management by persons for the alleged purpose of looting the investment company". That complaint also alleged that Cryan and his associates elected the purchasers of stock in the service company to the board of directors *of the investment company* and thereupon resigned as directors and officers of that company, leaving the purchasers in complete control of it, all without any action on the part of its stockholders, and all contrary to the *express* provisions of the Act. It further alleged that thereupon the purchasers attempted to loot the investment company and to pay for the stock of the service company out of the assets of the investment company.

Section 36 is *precise* in confining itself to activities of persons in certain capacities *when acting "in respect of* [*the*] *investment company."* These words petitioner ignores. When officials *of a service company* act in their capacity as *its* agents, performing *its* work, in respect of *its* duties toward the investment company, their acts would constitute its acts "in respect of [the] investment company." But when they act in their individual capacities, selling their own stock to outsiders, their acts are not its acts and are not "in respect of [the] investment company".

7. The essence of petitioner's argument is that any excess in the price of the stock in the service company over physical asset value is an asset of the investment company because it must be "payment for [the] fiduciary position." But no fiduciary position can possibly be sold because, we have seen, sale of a controlling block of stock terminates the service contract regardless of price. It may be that one of the factors leading the purchaser of stock to pay more than the bare physical asset value for the stock is a hope of persuading the investors to renew the contract. But Congress made it legal for the purchaser to try to persuade the investors and to succeed if he could.

Moreover, the theory that any value attaching to that hope or expectation belongs to the investment company ignores the most elementary concept of contracts, that every contract has *a separate value to each party to the contract.* Otherwise, no contract would be made. Here the value to the Trust Fund is that it obtains services. The value to the other side, the service company, lies in the fees received. To hand *that* value to the Trust Fund is to destroy the essence of contracts, which is that the contract must have a value to each side. The value, if any, of a hope that the contract, when terminated by any act specified by law, may be renewed and fees continued, is a value that pertains to the service company's side of the contract, not to the investment company's side.

A corporate fiduciary must perform its fiduciary duties with fidelity, but it is entitled to make a profit from its services. In the hands of the owner of stock, its worth includes the capitalized

value of the probable net earnings. And not even petitioner would contend that while the stock remains unsold the portion of its value attributable to the capitalized expectation of earnings belongs in equity to those for whom the trust company or other corporate fiduciary performs services. No more does it become their property when the stock is sold, for as the Court of Appeals cogently observed (Pet. App. 38), it "no more represents an asset of Trust Fund than do the current profits to the service company, as received." If, as petitioner argues, sale of the stock at a profit means a profiting from the fiduciary relationship, by identical reasoning receipt of dividends on the stock is a profiting from the fiduciary relationship, for the dividends are the fruit of fees received.

Petitioner's egregious fallacy is also shown by another fact on which the Court of Appeals commented (Pet. App. 38):

> "Appellant [petitioner] has conceded that a stockholder of a service company may make a gift of the controlling stock, subject only to the automatic termination provision of § 15. This could not be true if any value in this stock in excess of net asset value belongs to Trust Fund."

Whether the stock is retained by the original holders, or given away, or sold for much or little, the same service fees are paid, so long as the investors approve the service contract, which they can always terminate on 60 days' notice, Act, Sec. 15(a)(3). Nothing is taken from the coffers of the investment company; no burden is added.

8. All petitioner's citations are an effort to apply farfetched analogies. But, as the Court of Appeals said (Pet. App. 38):

> "* * * the general principles of equity announced in the cases cited by appellant provide no basis for attaching a 'gross misconduct' or 'gross abuse of trust' label to the transaction described in the amended complaint."

For example, petitioner would liken the sale of control of the service company to the attempted sale by a trustee of his office

(e.g., Pet. 12, 13). But a trustee cannot sell his office at all, whereas a stockholder in a corporation may sell his stock. Inherent in the concept of a corporation, and therefore in the concept of a corporate fiduciary, is the right to sell the ownership of the corporation by selling its stock. Controlling blocks of stock in trust companies are frequently sold and at prices capitalizing on hoped for earning power. Congress specifically recognized that corporations may act as investment advisers and the like (e.g., Act, Sec. 2(a)(4), and Section 15). And it contemplated that from time to time the stockholders would be selling controlling blocks of stock, because in Section 2(a)(4) it stated the consequences, viz., termination of the service contract. Since stock in a corporate fiduciary can be sold, the analogy to the sale by a trustee of his office is seen to be simply false. What is left is the argument that if enough is sold to constitute control, the price is subject to restriction. But this is not analogy. It is legislation. And it is legislation Congress did not choose to enact.

Some of petitioner's citations involve the situation where a member of a class who assumes to exercise or enforce a class right seeks to sell it for his own profit;[19] these are plainly not in point.

Other citations relate to the rights of a corporation or its minority stockholders in the event of sales of their position by directors or management of *that* corporation, sometimes achieved by sale of stock and sometimes not. These cases are either "looting"

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19. In *Clarke v. Greenberg*, 296 N.Y. 146, 71 N.E. 2d 443, plaintiff in a stockholder's action sold out to defendant so as to permit dismissal. The decision merely applied the elementary rule that the plaintiff in a stockholder's suit enforces a corporate right, not a personal one.

In *Young v. Higbee Co.*, 324 U.S. 204, two stockholders appealed on grounds common to all from confirmation of a plan of reorganization in bankruptcy. They sold their stock to the adversaries so as to permit dismissal. As said in *Young v. Potts* (6 Cir.), 161 F.2d 597, 600, after remand, the purchasers "were not interested in buying stock,—they were buying-off" an appeal which jeopardized a plan by which their junior interests would obtain priority over all stockholders. The case merely held that members of a class "cannot avail themselves of the statutory privilege of litigating for the interest of a class" for their own benefit (324 U.S. at 213).

cases,[20] or involve misrepresentations to the minority,[21] or other extraordinary circumstances,[22] all constituting exceptions to the general rule that the holder of a controlling block of stock may sell it for the best price he can and that it is immaterial whether the price is enhanced by the control position of the shares. 68 Harv. Law Review 1274, 1275; *Seagrave Corp. v. Mount* (6 Cir.) 212 F.2d 389, 395.[23]

We need not pursue these exceptions to the rule because they relate to the duty of those in control of a corporation to *that* corporation itself or to the minority stockholders therein—not to outsiders. No case suggests that the majority stockholders of a corporation owe some duty, in respect of their shares, to *outsiders* for whom the corporation performs services. In "The Sale of Controlling Shares", 70 Harv. Law Rev. 986 (April 1957), the author remarks that no court endorses the theory that one who sells a controlling interest in a corporation sells an asset of *that* corporation (p. 987). Yet petitioner would extend the theory to a wholly different set of relationships, already governed by a

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20. Directors sell their positions knowing that the purchaser seeks control of the corporation in order to loot it and thereafter he does loot it. In *Moulton v. Field* (7 Cir.), 179 Fed. 673, one defendant "purchased" a management contract from the corporation's manager. Then, controlling the corporation, he caused it to buy from him an utterly worthless list of names for $200,000. The suit was to recover from him, for the corporation, that sum which had been taken from its treasury, not the sum paid by him to the former manager. In *Benson v. Braun,* 286 App. Div. 1098, 145 N.Y.S. 2d 711, the complaint was held sufficient because the charge was one of sale with knowledge by the sellers of the buyer's intention to loot (so noted, *Benson v. Braun,* 155 N.Y.S. 2d 622, 626).

21. E.g., *Porter v. Healy,* 244 Pa. 427, 91 Atl. 428.

22. In *Perlman v. Feldmann* (2 Cir. 1955), 219 F.2d 173, during the steel shortage of the Korean War, the controlling interests in a corporation manufacturing steel were able to get a large premium for their stock because to the seller's knowledge the buyer, a steel user, wanted an inside track on buying steel without paying gray market prices. See *Perlman v. Feldmann* (D. Conn.), 154 F. Supp. 436, 442. The opportunity of charging gray market prices was said to belong to the corporation, and the majority stockholders had no right to sell it for their own profit.

23. Accord: *Tryon v. Smith,* 191 Ore. 172, 229 P.2d 251 and cases cited; *Keely v. Black,* 91 N.J. Eq. 520, 111 Atl. 22; *Benson v. Braun,* 155 N.Y.S. 2d 622, 625.

different type of regulation specifically and explicitly enacted by Congress.

Where shareholders sell a controlling block of a corporation's stock, the minority stockholders in *that* corporation must accept the situation unless equity intervenes. Their own investment thus becomes subjected, willy-nilly, to the management of the purchasers. This fact is the basis of equity's concern in the special situations noted above. But the investors *in an investment company* are not compelled to accept the purchasers of control *of a service company* for any purpose, because Congress has provided that the transfer of control terminates the service contract. If the investors do accept the new situation, *they do so voluntarily by voting to reinstate the service contract.*

This very fact sweeps away petitioner's quixotic effort to invoke the familiar principle that one may not occupy inconsistent positions.[24] Petitioner's effort to apply that principle consists of the argument that (p. 16) the sellers will seek the best price rather than look for buyers "most qualified to assume the fiduciary responsibilities." But the investors are not saddled with the buyers. And no one would suggest that the seller of stock in a trust company or a bank having a trust department must sell at physical asset value for fear he might not seek buyers best qualified to run the bank.

As noted by the Court of Appeals (Pet. App. 38):

> "Under the service contract, the service fees are not based on the number of transactions in Trust Fund, or on the amount, kinds, or values of securities bought, sold, or held by Trust Fund. No manipulation of Trust Fund investments can increase the service company's profits. The fees are based solely on what the investors pay in."

9. Petitioner's theory makes of Section 36 a beast of burden sagging under a load too great for it to carry. By its terms Sec-

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24 It cites *Woods v. City National Bank & Trust Co.*, 312 U.S. 262, and *Weil v. Neary*, 278 U.S. 160, which relate to compensation and fee splitting of trustees, attorneys, and bondholders' committeemen in bankruptcy proceedings who represent conflicting interests.

tion 36 can apply only to persons in official capacities, either investment adviser or principal underwriter itself, or directors or officers of the investment company. In fashioning a theory on such a foundation, petitioner reaches a curious result: A stockholder of a service company holding no office may sell any number of shares at any price, however large. But if he is a director, he may do so only if he sells a block of 25% or less of the stock. If he sells more, he can receive only physical asset value. He may sell 10%, 15% or 20% of the stock not only for more per share, but for more in the aggregate, than he may sell 26%. Yet if he owns all the stock, he may give or bequeath it all; he may even sell it all at any price, if he but sell it in equal blocks to 4 unrelated buyers; if he sells to 3, he can do so only at physical asset value.

A construction of a statute that produces distinctions like these and which deduces a regulation of the price at which stock in a service company can be sold from a section that neither refers to directors or stockholders of that company nor speaks of sales or price passes all understanding.

CONCLUSION

The petition for a writ of certiorari should be denied.

Dated: San Francisco, California, August 26, 1958.

Respectfully submitted,

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(Appendix Follows)

APPENDIX

Pertinent Provisions of the Investment Company Act of 1940, 54 Stat. 789, 15 U.S.C. §§ 80a-1 et seq.:

Sec. 1(b):

* * * it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * * * * * *

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders; * * *

Sec. 2(a)(4):

When used in this title, unless the context otherwise requires—

* * * * * * *

(4) "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; * * *

Sec. 2(a)(9):

* * * * * * *

Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. * * *

Sec. 15:

(a) After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

(b) After one year from the effective date of this title, it shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract, unless in effect prior to March 15, 1940—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment by such underwriter.

(c) In addition to the requirements of subsections (a) and (b) it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

(d) It shall be unlawful for any person—

(1) to serve or act as investment adviser of a registered investment company, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as investment adviser thereunder; or

(2) as principal underwriter for a registered open-end investment company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as principal underwriter thereunder:

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